Chapter 35

The Appraiser's Sales Comparison Approach

INTRODUCTION

The most commonly used appraisal technique is the sales comparison approach. The fundamental concept underlying this approach is that market data usually provide the best indication of market value for a house. The appraiser's task is to identify competitive properties that have sold recently on the local market and to collect basic information about the terms of the sales and the physical characteristics of the properties. Working with these sales prices and using an adjustment process the appraiser develops estimates of what these properties would have sold for if they had possessed all basic and pertinent physical and economic characteristics of the subject property. The key concepts of the sales comparison approach are (a) the selection of comparable or competitive properties and (b) the adjustment process.

SELECTING COMPARABLE PROPERTIES

Selecting comparable (competitive) properties to use in the sales comparison approach depends on an analysis of the characteristics of the subject property and of the profile of similar properties that have sold in the recent past. From this very heterogeneous group of previously sold properties, the appraiser finds the ones that are most like the subject property in terms of physical features, location and neighborhood features, time of sale, property rights, and conditions of sale.

(A) PHYSICAL FEATURES OF THE SITE AND THE IMPROVEMENTS - Truly comparable properties are as similar as possible to the subject property in site-specific factors. There should be little, if any, difference in the physical characteristics of the sites such as size, frontage, shape, topography, drainage and soil quality. The improvements should match closely in physical features, physical condition and structural description; there should be virtually no difference in the quality of construction between the subject property and the comparables. Any minor differences in physical features between the subject property and the comparables require an adjustment to the sales price of the comparable property. (A discussion of the adjustment process appears later in this chapter.)

(B) NEIGHBORHOOD FEATURES - Ideally, the comparable properties should be adjacent to the subject property. The comparable properties should be in the same neighborhood; but if they are located in another neighborhood, it should be a neighborhood very similar to the one in which the subject property is located, based upon the appraiser's analysis of neighborhood characteristics.

(C) TIME OF SALE - The date of the comparable property's sale is an indication of the market circumstances under which the comparable property sold. Ideally, the sale of the comparable properties should reflect the current market period—that is, a period of time in which major economic and demographic factors affecting the market remain unchanged. If the comparable properties did sell in the same market, there is little need for an adjustment in their sales prices for date of sale. If the comparable properties sold several months to one year in the past, an adjustment
may be needed for the changes in the economic and demographic conditions that affect both the demand and the supply sides of the market.

(D) FINANCIAL TERMS OF THE SALE - The search for comparable properties involves analyzing the financial terms under which they sold. To avoid inconsistencies, the subject and the comparable properties should have the same financial arrangements, for example, conventional mortgage, FHA/VA mortgage, or purchase money mortgage. If the financing is similar, the adjustment process easily handles minor variations in the mortgage interest rate, in the length of the loan, or in the amount of the downpayment. If the mortgage interest rate paid on the comparable property is greater than the current rate a buyer will pay on the subject property, if the required down payment is higher than typical in the market, or if the maturity of the loan is shorter than typical in the market, the appraiser makes a positive dollar adjustment to the comparable property’s sales price. The underlying reasoning is that those conditions reduced the buyer's purchasing ability and that without these stringent conditions the buyer would have been able to pay a higher sales price.

(E) THE PROPERTY RIGHTS - In the typical situation, the buyer buys property as a fee simple estate in real property. The buyer has the right to use, possess, exclude and dispose of the land along with the air and mineral rights. If the subject property is a fee simple estate, the comparables must be fee simple estates at the time of sale. If the subject property has air and mineral rights, the comparable properties must have air and mineral rights at the time of their sale. If the subject is a fee simple estate and one of the comparables is not, the appraiser either eliminates that comparable from consideration, or adjusts to reflect the difference in property rights. Easements and restrictive covenants limit the owner's right to use a fee simple estate. If one of the comparables has an easement and the subject property has none, the appraiser adjusts the sales price of the comparable upward to overcome the reduction in value caused by the limit on use.

(F) CONDITIONS OF THE SALE - Five necessary conditions of the sale of a property define a competitive market. They are the following:

(a) the buyer and seller have a genuine interest in buying or selling the property and are free of any undue pressure to enter the transaction;

(b) both parties to the transaction have adequate and generally equivalent knowledge of the market in which they are dealing;

(c) being well informed, both parties act rationally and in their own self-interest;

(d) the property was on the market for a reasonable amount of time; and

(e) financing was on terms generally available and typical for the type of property.

If these market conditions were missing in the sale of a certain property, it is not a comparable property, even if it is similar in all other respects to the property being appraised. From a list of properties, an appraiser would reject the ones that sold with unusually low down payments and below-market interest rates or make a “cash equivalent” adjustment.

THE ADJUSTMENT PROCESS
In the ideal situation the subject property and all the comparable properties are identical in every detail. This situation could arise only if recent (yesterday's) market sales occurred for units that contained identical structures on identical lots adjacent to each other, all financed by the same financial institution under identical terms. In this case there should be no need for adjustments because the selling prices of the units would almost assuredly be the same. Consequently, the estimated selling price of the subject property would be equal to the selling price of the comparable properties but this ideal situation is very unlikely. If the comparable properties differ in some way from the subject property, adjustments to their sales prices may be necessary to compensate for the differences. The appraiser makes adjustments only to the sale prices of the comparables, not to the subject property, since only the comparables have established sales prices as a result of being closed transactions. The goal of the adjustment process is to make a comparable property as similar in value to the subject property as possible. If a comparable property sale is lacking a feature which the subject has, the appraiser adds the value of the feature to the comparable's sales price. If the comparable has a feature that the subject is lacking, the appraiser subtracts the value of the feature from the comparable's sales price. The process for making these adjustments is simple.

First, the appraiser considers the effect that the presence or absence of a property feature or characteristic has on the actual sales price of the comparable property. If the subject property contains an item or a characteristic that a hypothetical buyer would pay extra for and the comparable property does not have that item or characteristic, the appraiser adjusts the sales price of the comparable property upward. For example, if the subject property were 200 square feet larger than the comparable property, the appraiser would adjust the sales price of the comparable upward to reflect the additional value added by the additional space. On the other hand, if the comparable property contains a feature that the subject property does not have, the appraiser adjusts the sales price of the comparable property down by the dollar value of that feature. For example, if the subject property were 200 square feet smaller than the comparable property, the appraiser would adjust the comparable's sales price downward to reflect the reduction in space.

Since real estate is not a standardized commodity it is not surprising that perfect substitutes are difficult to find. There are always some differences in physical features of the on-site improvements. If the physical features are similar there may be differences in locational and neighborhood features. If the location and neighborhood features are similar, there may be differences in the time at which the sale of the comparable took place and the time of the appraisal of the subject property. Experienced appraisers understand which features are easy to handle in the adjustment process and thereby yield more accurate results and which features are difficult to measure and thus difficult to specify as a dollar adjustment. One of the factors most difficult to measure in dollar terms is the impact on value of neighborhood and locational features. Consequently, appraisers try to find comparable properties that are in the same neighborhood as the subject property. Use of such properties eliminates the need for large adjustments to overcome differences in the quality of the physical and economic environment around the subject property.

Another factor difficult to measure in dollar terms is the difference in the economic and demographic variables of the markets in which the subject and comparable properties sell. To eliminate the need for adjustment, the appraiser attempts to find comparable properties that sold in the immediate or the recent past. If the appraiser
can find such comparable properties, the assumption is that the subject property will sell in the same market as these comparable properties and no adjustment is necessary. For example, population growth in the community may have declined from a high rate last year to a low rate this year, and the appraiser may expect this low rate to continue into the future. Due to this major change in a demographic factor, the appraiser would try to avoid selecting properties from last year as comparable properties for a sale in this year because a sale from last year may warrant an adjustment. The appraiser tries to locate comparables within the same market as the subject to minimize adjustments. The fewer adjustments that are necessary typically leads to a more reliable appraisal.

If the appraiser can control the neighborhood factors and date-of-sale considerations and thereby minimize, or totally eliminate, differences in these categories, the adjustment process only needs to consider features that are much easier to measure in dollar terms. Consequently, the accuracy of the adjustments increases; and the adjustment process is open to fewer criticisms. The adjustments that the appraiser can document and justify most easily are those representing differences in the physical features of the lot such as its size and shape and the physical features of the improvements such as square feet and condition. Cost data or market evidence in the form of sales-price differences for houses with different features provides the necessary information for the appraiser to make the adjustments.

**A NUMERICAL EXAMPLE OF THE ADJUSTMENT PROCESS**

Exhibit 1 is a numerical example of the adjustment process. The items listed along the left side of the table are items of comparability. This list can be very specific identifying all subcategories of site, improvement, and neighborhood features, or it can be very general including only the major topic headings such as physical features of the lot and of the improvements and neighborhood features. The appraiser determines the factors to display in the exhibit as they appear in the left column.

The attributes of the subject property are presented in the second column in Exhibit 1. The physical features of the subject property are the size of the lot, the shape of the lot, landscaping, square feet of livable space in the structure, structural condition, the age of the structure, and the age of the mechanical systems. In addition, the subject property has two special features, a cement block patio and attic storage space.

The neighborhood features of the subject property appear in general terms, "Good, Average, and Fair" in descending order. The neighborhood has a high quality school system and good public services provided by the local government. The neighborhood contains off-site improvements that are in good physical condition. The neighborhood's location in the urban area provides an average level of accessibility to employment opportunities. The subject property is fee simple and there are no easements against the property. When the property sells, the financing will be by a conventional mortgage at an interest rate of 6 percent per year, a loan maturity of 30 years, and a down payment of 20 percent. The appraisal assignment is to place a current market value on the property and its fixtures.

**EXHIBIT 1  Characteristics of the subject property.**
With this information about the subject property the appraiser can search for comparable properties. From a pool of sold properties, the appraiser first checks for sales that have taken place in the recent past in the same subdivision or a similar and proximate neighborhood. This pool of sales obtained from a respected database could contain at least three but could also contain 10 to 20 sales. The better the input information is about the subject property, the better the matches and the fewer the sales in the pool. From the pool of sold properties, the appraiser chooses at least three of the most comparable or competitive sales as illustrated in Exhibit 2.
Exhibit 2 displays adjustments to the sales price of each comparable. These adjustments rely on the pool of sales and other sources of data about the market in which the subject and the comparable properties exist. For example, two physically similar properties in the same market but in different school districts can sell for a different price.

In Exhibit 2 comparable property #1 sold six months ago, comparable property #2 sold one month ago, and comparable property #3 sold twelve months ago. Ideally, the appraiser would like to see the subject property sell today and the three comparable properties to have sold yesterday. But in the real world, the guiding principle is that the subject and comparable properties should sell in the same market under the same economic conditions. Generally, this means that demand and supply conditions in the market should be similar for the study period. In the numerical example in Exhibit 2 this is one year. Ideally, the time period should be as short as possible. So, the comparable properties might be limited to a short time period like six months or even a shorter time period.

The appraiser now begins the analysis phase of the sales comparison approach. First, the appraiser analyzes the property rights between the subject and comparable property #1. Comparable property #1 is fee simple ownership and has no easements affecting so no adjustments are warranted. Financing considerations are made next. Comparable property #1 sold under conventional mortgage financing at the interest rate that prevails in the current market, so no adjustments are warranted.

The next consideration is market condition also known as time of sale conditions. Because comparable property #1 sold six months ago, and property values have increase by 2% per year over the last year, an adjustment must be made. To perform the analysis the appraiser first investigates the direction of the adjustment. If comparable property #1 were to sell today it would sell for more because of the appreciation in the market. The adjustment to comparable property #1 is positive. The magnitude of the adjustment is 1% of the sales price. One percent occurs because it is one-half of the 2% appreciation per year. So, $175,000 times 1% = $1750. Using similar logic, the adjustment for comparable property #3 is $3300.

The appraiser then analyzes the location/neighborhood features and finds that the neighborhood surrounding comparable property #1 is inferior to the neighborhood surrounding the subject property with regard to the quality of the public school but superior with regard to the physical condition of the neighborhood. Using recent sales for comparable properties, the appraiser determines from these market conditions that comparable property #1 would have sold for $6000 more if it were in a public school system similar to the subject property. Also, the appraiser determines from market conditions that if comparable property #1 were in a neighborhood similar to the subject property would be - $4000.

Physical characteristics of the site are the next characteristics. In the exhibit the subject property and comparable property #1 are similar in each site characteristic except a cul-de-sac position. Using recent sales for comparable properties, the appraiser determines from these market conditions that comparable property #1 would have sold for $2000 more if it were in a cul-de-sac.
Physical characteristics of comparable property #1's improvements are now compared with the subject property. The two properties have the same number of square feet of livable space so no adjustment is necessary. However, the condition of the structures is not the same; comparable property #1 is inferior to the subject property. This could occur because of necessary repairs or functional obsolescence. The judgment of the appraiser is that comparable property #1 would have sold for $1,000 more if the inferior condition was not present.

Comparable property #1 is ten years old and the subject property is only five years old. This difference in age produces an adjustment. Comparable one has five additional years of wear and tear on its structural members and its fixtures. The appraiser judges the additional wear and tear to be $5,000 and adds a positive $5,000 as the adjustment to the sales price of property. The underlying assumption is that comparable property #1 would have sold for $5,000 more if it had been five years old instead of ten.

Next, the appraiser notices that comparable property #1 contains a mechanical system different from that of the subject property. In this example, we will use the market adjustment amount derived from the market of $2000 for the HVAC. The appraiser subtracts the amount the market would pay for the HVAC from comparable property #1 to handle the difference in the age of the mechanical system. In all other respects, comparable one is identical to the subject property. Adding and subtracting the adjustments to comparable one, yields a positive net adjustment of $9,750. By adding this figure to the actual price of $175,000 the appraiser obtains an adjusted sales price for comparable property #1 of $184,750. This adjusted sales price is the sales price of comparable #1 under the assumption that it is as similar as possible to the subject property.

The appraiser then goes through a similar analysis for comparable property #2 and the subject property and comparable #3 and the subject property. The necessary dollar adjustments are made in a similar manner as discussed in reference to comparable #1. A discussion of the adjustments to comparable properties #2 and #3 is not provided.

After making these adjustments, the appraiser has three adjusted sales prices for the three comparable properties. The appraiser now estimates the sales price of the subject property from the adjusted sales prices of the comparables as shown in the adjustment grid exhibit.

The accepted procedure to determine the market value of the subject property is to review each sale and judge its comparability to the property being appraised. Generally, the fewer and the smaller the gross amount of adjustments to a property, the more weight that sale is given. The arithmetic determination of this process is the calculation of the absolute or gross adjustment to each comparable property. The absolute adjustment is obtained by adding together all of the adjustments for each comparable property ignoring the negative sign. The absolute adjustments are $21,750, $34,000 and 24,300 for comparable properties #1, #2 and #3 respectively. Comparable property #1 has the smallest absolute adjustment signifying the fewest and the smallest gross amount of adjustments to a property.

The final value estimate is a judgment the appraiser based on all the information available. Given these facts, the appraiser could establish the market value in the sales comparison approach as a single estimate of $184,750. (This value could be rounded up to $184,800 or even $185,000.)
In actual practice an appraiser might calculate the simple average of the three adjusted sales prices to get an estimated market value. The three comparable properties carry the same weight in the averaging – 33 and 1/3% or 1/3rd. Other appraisers might calculate a weighted average sales price by assigning different weights to each property such 50%, 20% and 30% to the three comparable properties respectively. These averaging procedures are not the recommended procedures.

As a critical part of the adjustment process, the quality of the comparable properties used in the analysis needs to be evaluated. The guidelines for this evaluation are stated in the FNMA Selling Guide 2010 in Section B4-1.4-17 which is available on the Internet. Consider the following values for these ratios:

- The ratio of each line item adjustment to the sales price should not exceed 10% of the sales price of the comparable property.
- The net adjustment for the comparable property to the sales price should not exceed 15% of sales price of the comparable property.
- The absolute adjustment for the comparable property to the sales price should not exceed 25% of sales price of the comparable property.

When these ratios exceed these guideline values the appraiser should explain the reason for the deviation from the norm. The appraiser needs to comment on reasons for using this specific comparable property and not using a comparable property that is more similar to the subject property.

These ratios were originally proposed by FHA and FNMA as guidelines to evaluate the selected comparable properties. Conventional lenders stipulated these guidelines as necessary requirements for the appraisal for purposes of granting a loan. Currently in Georgia, these guidelines have been stated as requirements.

The three comparable properties used in the adjustment process pass these three evaluation guidelines. The best of the three comparable properties is #1 with an absolute adjustment ratio of 12.4%. The weakest of the three comparable properties is #2 with an absolute adjustment ratio of 20%.

**CONSIDERATIONS OF THE SALES COMPARISON APPROACH**

The cornerstone of the sales comparison approach is the principle of substitution; based on the premise that a buyer would not pay more for a property than what they would pay for an equal substitute. In order for the principle of substitution to work in the sales comparison approach, good comparable sales must exist. If few or no comparables exist in the subject subdivision, the appraiser expands the search for comparables. The further away from the subject the comparables are, the more likely there will need to be adjustments to reflect market preferences. The larger in dollar amounts the adjustments are and the number of adjustments occurring may affect the reliability of the market value opinion. This would be a more complex appraisal assignment than the one with many comparables in the subject subdivision or neighborhood. Another approach, like the cost approach, may help support the sales comparison approach in a more difficult assignment.

Sometimes a property type is so unique that it does not sell frequently in the market. The sales comparison approach may not be the best approach for this type
of property. Another approach, like the cost approach, might represent the best indicator of value.